Service Date: June 5, 2006

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

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IN THE MATTER OF NORTHWESTERN ENERGY, Annual Application for Approval of Monthly Gas Cost Tracker True-Up, Projected Gas Costs, and Gas Transportation Balance	))))	UTILITY DIVISION DOCKET NO. D2005.5.87

DISSENT OF THOMAS J. SCHNEIDER, COMMISSIONER

The Office of Montana Consumer Counsel (MCC) handed the Commission an overwhelming case of imprudence by NorthWestern in failing to acquire adequate natural gas storage levels for the winter of 2005-06 under compelling market price conditions. MCC witness Mr. Donkin's imprudence testimony that was *entirely within the letter and scope of the* ***Settlement Agreement*** *as described by NWE's Mr. Corcoran and MCC's Mr. Nelson in the March 10, 2005 hearing.* It is important to recognize that MCC has rarely challenged prudence in Montana gas cases. Furthermore, it is MCC witness Donkin who supported NWE's 2003-04 and 2004-05 procurement practices in reaching the Stipulation with NWE in those trackers upon which the NWE/PSC ***Settlement Agreement*** hinged.

The entire record, especially the transcript in this docket, provides substantial evidentiary support for finding imprudence and disallowing excessive gas supply costs. The essence of the imprudence issue is captured in the cross-examination of MCC witness Donkin (A) by Chairman Jergeson (Q):

> Q. Okay. You heard my questioning of Mr. Bradshaw about at what point does the exercise and use of a variety of kinds of hedges, from the most fundamental to the more sophisticated, at what point is there a risk of crossing the line and engaging in speculation. And certainly, speculative behavior would—would qualify as probably something that we wouldn't look at as very prudent. Has there been any of the performance, as you've analyzed it, across the continuum of how they use their storage that would indicate to you that—that they either are or have been pressured into or that there's speculative value in what's going on?
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> A. Yes.
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> Q. Could you explain what?

A. Sure. It's what I touched on previously, and that is, looking at the market going back to March of '05 through the summer, when the company's policy is consistently based on a rejection of the validity of the price information that is being reviewed, and the decision is, no, we don't want to put more gas into storage because we think that these near-term futures prices are wrong, we think prices are more likely to come down; yet, each month, they keep going higher, and each month, they kept saying not only are the near term prices going up, but the heating season prices are going up even more. It should have been a compelling set of factual information that would tell the manager of the gas storage resource it really makes sense to put some more gas in the ground. But instead, they didn't do so because they believed the market was wrong.

To me, that's speculation. That's taking a bet. They were betting the prices were going to come down relative to what the market price information was saying, and they didn't have an offsetting hedge to protect themselves and their customers in the event that bet was wrong. That's speculation, that's gambling." Tr. 227-228

MCC witness Donkin's (R) responses to Commissioner Raney (Q) on appropriate storage levels and related market price signals were equally powerful and persuasive:

Q. Earlier today, I explored with an NWE witness in which he said that for reliability purposes, there has to be about 4-and-a-half Bcf in storage on average year…But if—if 4 and a half or somewhat more is needed for reliability, then is the remaining 1 Bcf or 1-and-a half Bcf enough to do very much towards affordability, or should there have been significantly—or should they use their storage to a larger capacity?

R. In my judgment, the information is compelling with respect to this heating season, and that is, not only is 4 and a half not enough, 5.7 is not enough; it should have been 7.7 billion. It should have been at least as much as the previous year, because in the previous year, the inter-seasonal price differentials weren't as great as they were going into—or prior to this heating season. Yet, the previous year, they did 7.7 billion. The year before that, they did 7.2 billion…there are no certainties in the gas supply world when it comes to prices. But there was an awful lot of evidence out there suggesting that this winter, gas supply prices were going to be a lot higher than they were in the previous injection season. And in fact, they have been. The market signals were correct." Tr. 215-216

Q. …I mean, if 9 billion is your capacity and 4 and a half is the minimum you need to protect on an average year, how much do you have to have so that you can actually use storage as hedging on affordability?

R. I said that there's this number that I think was the minimum amount needed going into this heating season… But…that there could be circumstances at some future point in time that would suggest a lower number…*We don't want*

> *to tie the company's hands. We just want to let them know that—or I want to let them know that they shouldn't be ignoring what the futures prices are telling people about price expectations and it's wrong to look at prices and say, I don't believe them, I think that prices are going to come down**, especially if you don't have an offsetting hedge to protect yourself and your customers when you go bucking the market like that**.* I mean that's really what happened here, is they rejected the market prices; their belief was these prices are wrong, we're not going to aggressively pursue storage. And as a result, there wasn't enough to save customers a lot of money once you got to the heating season, especially if heating season temperatures and gas supply requirements were at normal or greater levels." Tr. 216-217. Italics added

The strategy adopted and pursued by NWE was fundamentally different from and more risky than that employed during the past two tracker periods upon which the ***Settlement*** was based. Rather than entering the 2005-06 winter heating season at 7.7 Bcf of storage and a combined fixed price hedge (between storage and forward fixed price purchases) of 77-78% as in the prior 2 years, NWE targeted 5-6 Bcf of storage (actually acquired 5.7 Bcf) and achieved about 50% fixed price hedge (Tr. 31) entering the winter heating season. The 2005-06 fixed price hedge was dramatically below ***Settlement*** period levels and its own 75-80% target in those earlier base periods. Tr. 280-285

NorthWestern's reliance on strategy documents of 3/1/05 and 4/19/05, which were never presented to the Commission and were not the basis of the Settlement, is misplaced. NWE's tail-end weighted storage refill strategy flew directly in the face of continuous futures market price differentials for the 2005-06 winter season, based on its internal assessment of market fundamentals -- *the same market factors (national storage levels, relatively high gas prices, summer weather forecasts, expected on-line dates and capacity of nuclear plants, historic and rising oil price levels, annual hurricane season, etc.) that are certainly incorporated by futures markets*. Tr. 229-230

NWE repeated its mantra of "reasonableness, ratable takes, layered refill and avoiding guessing" so often, they must have come to believe it. For example:

"What we tried to implement and what we did implement is a structured, orderly process. We didn't try to guess what the market was, we didn't try to chase the market, we procured – layered in gas on an orderly basis and implemented a hedging strategy that way". NWE's Mr. Hines, Tr. 48

So it's a layering strategy, if you will. It's no different, in my mind, as if you have a retirement, you invest it on a monthly basis. You don't take it all at the end of the year and throw it into the bank at one point in time or into a particular stock at one point in time and hope you hit it right. It's a conservative approach to layering in prices to provide a hedge to customers." Hines, Tr. 56

"Again, I think if – if you think you that you are going to out guess the market, it's difficult to do that." Mr. Bradshaw Tr. 179

However, NWE's storage injection facts and explicit strategy of tail-end weighted storage refill, given actual market price conditions, ***belie*** their mantra! Donkin exposed NWE's guess -- its gamble. The later NWE waits to fill storage, the more limited its options become and the more risk it incurs. Its flexibility to refill to greater than 7 Bcf requires constant refill, and its flexibility to use its storage resource to respond to severe weather and / or pricing circumstances throughout the winter season is sacrificed or jeopardized by relatively low storage levels. Extreme price levels and volatility occur with increasing frequency in natural gas markets (e.g., 1995-96; 2000-01; 2003 and 2005-06) as described by MCC's Donkin and shown on his Exhibits. Risk mitigation is first and foremost designed to avoid extremely bad outcomes.

The Commission, in its public work session (decision meeting) discussion on its reasoning, emphasized the expected level of the proposed disallowance of $1,300,000 would be "immaterial" for customers and not worth the risk of damaging NWE's credit rating. Interestingly, the "immaterial" rationale, expressed forcefully by the Commissioners, does not appear in the Order. Nevertheless, Mr. Donkin's response to the Chairman's cross-examination concerning materiality and overselling the benefits to customers of a disallowance is on target:

> Q. I know accountants, during audits, get into the issue of materiality…if the $9 million disallowance is approved, the average NorthWestern customer will get a refund of, oh, I suspect spread over a period of time of about $54…And I don't mean to minimize the value of $54 to anybody…Aren't the flat-out, the fundamental markets just egregiously injurious to the customer and that we're only going to be -- It's kind of like in gasoline prices where we might be taking the nine-tenths off; and it's still 2.19 or $2.35 or whatever the market is fundamentally going up and down.
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> R. Mr. Commissioner, in my judgment, whether it's $9 million or some other number, it produces a figure that's not immaterial. If it were $9 million, and if it were $54, that's a big deal in a state like Montana.
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> Q. Well I said I don't mean to minimize that number. But – but compared to what the markets are doing to the customers fundamentally, where they're at, at those levels they're at, I'm saying we shouldn't oversell to customers what the relief really means.
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> R. I don't know what you mean by "oversell". I do know that a point in time when gas prices and ultimate rate levels are at their historical peak, Montana ratepayers are being hammered. And I don't think we'd be here today talking about this if we thought it was, you know, a $100,000 issue. But it's not. And whatever the number ultimately turns out to be, it's big enough to make a measurable difference in a ratepayer's disposable personal income, especially when they're being hammered by these historically high utility bills." Tr. 231-232

In stark contrast, the Commission emphasized the risk and danger to NWE's credit rating and financing costs from such "immaterial" disallowance. The relative priorities are distorted along with sound regulatory practice. Would the Commission's substantive decision change had the excessive costs been material—say the $8.9 million estimate at the time MCC filed its testimony? It is crucial to recognize that principle of rigorous prudence review is directly sacrificed in that pragmatic reasoning and trade-off. Finding 32, related to NWE's post bankruptcy financial results, is outside the record in this Docket. Bottom line: NWE failed to mitigate or hedge the risks of gas price levels and volatility through adequate storage levels under compelling market price conditions pursuant to the ***Settlement Agreement*** -- thus exposing customers to unacceptable risk and excessive gas costs. Any action by credit agencies in response to reasoned findings of imprudence and cost disallowance must be laid directly at the feet of NWE. The Commission is responsible to do its job. Let credit rating agencies do their job.

NWE and, more importantly, Montana ratepayers dodged a bullet this past winter for the gamble that NWE made against the expected market prices facing consumers during the winter 2005-06. One of the warmest Januarys in history throughout the major consuming regions of the nation saved us from extraordinary economic impacts of $10-$13/dkt natural gas prices throughout the winter.

Of serious concern to me is NWE's disjointed gas default supply management (Tr. 28-30; Tr. 59-61) and lack of direct operation, use and control of its storage resources and supply portfolio to meet the loads of Montana customers at the lowest reasonable cost. A review of the transcript and data responses of NWE (PSC014-020) is deeply troubling. MCC's Donkin stated emphatically that the actual use and management of the storage resources during this past winter should be carefully examined, based on what he'd heard in live cross-examination of NWE witnesses. (Tr. 200-201) It is obvious from the transcript that the significantly lower storage level of 5.7 Bcf entering the 2005-06 heating season limited NWE's use of storage during the severe December weather and extreme prices because of concern about storage adequacy for the remainder of the winter. (Tr. 106-111) I am struck by the contrast in NWE's creativity and bold actions to enhance cash flow (storage deferrals and sales) and its reticence to mitigate extreme December supply costs in similar manner. It is essential that the Commission fully examine this issue in the upcoming tracker filing, including deferred storage use restrictions and any actual declarations of "constrained" or "critical" days, first identified in NWE's Initial Brief (p. 11) without any evidentiary basis.

NWE failed to act in a manner consistent with its 2003 and 2004 trackers and Settlement and to fully reflect and mitigate the price risk of its speculative storage refill levels and overall fixed price hedge for winter 2005-06 under much more compelling market price conditions. The PSC ought not shield NWE from imprudent actions. NorthWestern failed. The Commission let them off the hook. Ratepayers lost.